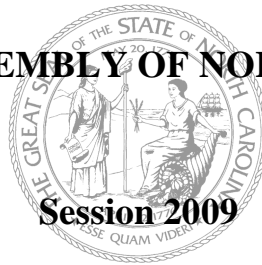


# GENERAL ASSEMBLY OF NORTH CAROLINA



## **FISCAL ANALYSIS MEMORANDUM**

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

**DATE:** December 1, 2010

**TO:** Revenue Laws Study Committee

**FROM:** Jonathan Tart  
Fiscal Research Division

**RE:** 2011 IRC Update

<b>FISCAL IMPACT</b>					
	<b>Yes (x)</b>	<b>No ( )</b>	<b>No Estimate Available ( )</b>		
	<b><u>FY 2010-11</u></b>	<b><u>FY 2011-12</u></b>	<b><u>FY 2012-13</u></b>	<b><u>FY 2013-14</u></b>	<b><u>FY 2014-15</u></b>
<b>REVENUES:</b>					
<b>(\$ millions)</b>					
Bonus Depreciation	0	-318.4	81.3	60.3	46.9
Section 179 expensing	0	-114.6	17.4	24.5	17.6
Increased Start-up Expense Deduction	0	-3.3	.2	.2	.2
Increase to Capital Gain Exclusion for Small Business Stock	Insignificant Impact				
Deduction for health insurance costs in computing self-employment tax	0	4	.1	0	0
Allow rollovers from	0	5.9	4.7	3.9	4.4

elective deferral accounts into Roth accounts					
Source rules for income on guarantees	0	3.3	1.9	1.9	1.9
Allow 457 plan deferrals to be treated as Roth contributions	Insignificant Impact				
Permit partial annuitization of non-qualified annuity contract	Insignificant Impact				
TOTAL	0	-423.1	105.6	90.8	71
<b>PRINCIPAL DEPARTMENT(S) &amp; PROGRAM(S) AFFECTED:</b> Department of Revenue					
<b>EFFECTIVE DATE:</b> Effective when it becomes law					

**BILL SUMMARY:** This proposal would update the reference to the Internal Revenue code used in defining and determining certain State tax provision. By doing so, North Carolina would conform to the changes made by the federal Small Business Jobs Act of 2010.

**CURRENT LAW:** North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.<sup>1</sup> The General Assembly determines each year whether to update its reference to the Internal Revenue Code.<sup>2</sup> Updating the Internal Revenue Code reference makes recent amendments to the Code applicable to the State to the extent that State law tracks federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. Maintaining conformity with federal tax law simplifies tax reporting because a taxpayer will not need to account for differing federal and State treatment of the same asset.

North Carolina income tax law conforms to the Code as of May 1, 2010.<sup>3</sup> After the last update to the statutory reference to the Code, Congress enacted the Small Business Jobs Act of 2010 in September

<sup>1</sup> North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

<sup>2</sup> The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation ... shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would ... be invalidated as an unconstitutional delegation of legislative power."

<sup>3</sup> Part 31 of S.L. 2010 31 updated the reference to the Internal Revenue Code used in defining and determining certain State tax provisions from May 1, 2009, to May 1, 2010. However, S.L. 2010 31 did not conform to the five year carryback of net operating losses incurred by large businesses. S.L. 2010 31 incorporated tax changes made by five federal acts: the Worker, Homeownership, and Business Assistance Act (WHBA), P.L. 111-92; Acceleration of Income Tax Benefits for Haiti Relief, P.L. 111-126; the Patient Protection and Affordable Care Act, P.L. 111-148; the Health Care and Education Reconciliation Act, P.L. 111-152; and the Hiring Incentives to Restore Employment Act (HIRE), P.L. 111-147.

2010, as P. L. 111-240 (2010 Jobs Act). The 2010 Jobs Act contains several tax law changes that may affect a taxpayer's federal taxable income for the 2010 tax year. Since North Carolina's definition of the Code does not incorporate these changes, a taxpayer whose taxable income is affected by the changes will have to make appropriate adjustments on the 2010 State tax return.

The 2010 Jobs Act enhances existing business tax incentives and partially offsets this revenue loss with changes which are expected to increase revenue. The incentives in the 2010 Jobs Act are not limited to small businesses, and the accelerated deduction for depreciation represents a major benefit to large businesses.

## **BILL ANALYSIS:**

The 2010 Jobs Act's significant business tax incentives are described below. The federal law changes which increase revenue are listed separately. The business tax incentives available at the federal level under the 2010 Jobs Act include the following:

- ***Extension of Bonus Depreciation*** – Bonus depreciation allows a business to claim more of a deduction up front and spread the remainder out over the normal depreciation schedule. However, over the life of the asset the taxpayer still receives the same benefit. The federal Economic Stimulus Act of 2008<sup>4</sup> provided a 50% first year bonus depreciation for qualified property acquired and placed in service in 2008. The federal American Recovery and Reinvestment Act of 2009 extended the 50% bonus depreciation provided to qualified property for an additional year through 2009. The 2010 Jobs Act extends the bonus depreciation for 2010 and is retroactive to the beginning of 2010.<sup>5</sup>

North Carolina decoupled from the extension of the bonus depreciation provisions in 2008 and 2009. The State delayed the impact of the bonus depreciation deduction in a manner similar to what it has done in the past: State tax law provides that a taxpayer may deduct the same amount of an asset's basis under State law as under federal law, it is just that the timing of the deduction differs. Under State tax law, a taxpayer must add back 85% of the accelerated depreciation amount<sup>6</sup> in the year that it is claimed for federal purposes. Then, in subsequent tax years, the taxpayer may deduct from federal taxable income the total amount of the addback, divided into five equal installments. This means that for State tax purposes, a taxpayer may deduct a greater depreciation amount in the outlying tax years, which will be the normal depreciation amount plus 20% of the accelerated depreciation amount the taxpayer had to add back.

The 2010 Jobs Act also allows taxpayers using the percentage of completion accounting method to benefit from bonus depreciation at the federal level for assets with a depreciable life of seven years or less. The percentage of completion accounting method might prevent taxpayers from receiving benefit from the bonus depreciation because the accounting method spreads expenses, including depreciation, throughout the life of a long-term contract. Under this accounting method, taxpayers could not deduct the bonus depreciation in the first year. Construction contractors use the percentage of completion accounting method. This provision is new.

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<sup>4</sup> Congress has authorized bonus depreciation several times to encourage business investment, specifically after September 11, 2001. The Jobs Creation and Worker Assistance Act of 2002 provided a 30% bonus depreciation allowance. The Jobs and Growth Tax Relief Reconciliation Act of 2003 extended the sunset and increased the amount to 50%.

<sup>5</sup> The property may be placed in service during 2011 for property with a recovery period of 10 years or longer and for transportation property (i.e., tangible personal property used to transport people or property).

<sup>6</sup> The accelerated depreciation amount for property placed in service in 2008 is 50%.

- **Enhanced section 179 expensing** – Section 179 allows the expensing of the purchase price of some business assets<sup>7</sup> in the year of purchase rather than taking depreciation<sup>8</sup> throughout the life of the asset. In other words, expensing trades a smaller yearly deduction over time for a larger deduction in year one.

Prior to the Emergency Economic Stabilization Act of 2008 (EESA), the section 179 expensing deduction was limited to \$128,000 of the cost of the property with a phase-out at \$510,000. The EESA increased the deduction limit from \$128,000 to \$250,000 with a phaseout at \$800,000 for the 2008 tax year. The American Recovery and Reinvestment Act of 2009 extended the temporary increase through 2009. The federal HIRE Act of 2010 extended the 2008 and 2009 increase through 2010. North Carolina conformed to those changes.

The 2010 Jobs Act expands the section 179 expensing deduction in three ways. The expansion is effective for tax years 2010 and 2011. The first year expensing is enhanced as follows:

- **Increase limit on expensing** – The 2010 Jobs Act increases the maximum deduction from \$250,000 to \$500,000.
  - **Increase phase-out threshold** – The 2010 Jobs Act increases the phase-out threshold from \$800,000 to \$2 million.
  - **Expansion of eligible property** – The 2010 Jobs Act expands the definition of qualified property to include qualified leasehold improvement property, qualified restaurant property, qualified retail improvement property, and computer software.<sup>9</sup>
- **Increase in amount allowed as a deduction for start-up expenditures** – Under the 2010 Jobs Act, a taxpayer may take a deduction of up to \$10,000 for start-up and organization expenses of the taxpayer's trade or business in 2011. However, the amount of the deduction is reduced by the amount by which those expenses exceed \$60,000.
- **Modification to exclusion for gain from certain small business stock** – The American Recovery and Reinvestment Tax Act of 2009 (ARRTA) temporarily increased from 50% to 75% the exclusion for qualified small business stock sold by an individual. The increased exclusion percentage is applicable to stock acquired after February 17, 2009 and before January 1, 2011. North Carolina conformed to ARRTA's temporary increase of the exclusion. When the stock is issued, the gross assets of the issuing corporation may not exceed \$50 million and the corporation must have at least 80% of the value of its assets used in the active conduct of one or more qualified trades or businesses. The 2010 Jobs Act increases the exclusion percentage to 100% for stock acquired after September 27, 2010 and before January 1, 2011.

The federal law changes in the Jobs Act which increase revenue include:

- **Deduction for health insurance costs in computing self-employment taxes** – The 2010 Jobs Act allows self-employed individuals to deduct the cost of health insurance for the individual and immediate family to determine income subject to federal self-employment taxes. Health insurance costs were already deductible for regular income tax purposes. The reduction in self-employment taxes affects North Carolina taxable income because self-employment taxes were deductible in

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<sup>7</sup> The business asset must be newly purchased tangible personal property that is used more than 50% for business purposes and is eligible to be depreciated under the Code.

<sup>8</sup> Generally, taxpayers take the Section 179 expensing deduction first and claim Section 168(k) depreciation on any remaining basis.

<sup>9</sup> Qualified real property is limited to a maximum deduction of \$250,000.

determining State taxable income. Self-employed taxpayers with health insurance costs will have larger State taxable incomes because less self-employment taxes were imposed and deducted at the federal level.

- ***Allow participants in governmental 457 plans to treat elective deferrals as Roth contributions*** – The 2010 Jobs Act gives participants the option to move retirement savings from government 457(b) plans to Roth accounts starting in 2011. The conversion will be taxable while the earnings and distributions from Roth accounts are generally tax free.
- ***Allow rollovers from elective deferral plans to Roth designated accounts*** – The 2010 Jobs Act allows retirement plans to offer participants the option starting September 27, 2010 to rollover distributions into Roth accounts within the same retirement plan. The rollover will be taxable while the earnings and distributions from the Roth account are generally tax free.
- ***Permit partial annuitization of a nonqualified annuity contract*** – The 2010 Jobs Act allows the owner of an annuity contract to begin receiving benefits based on a portion of the value of the annuity and leaving the balance of the annuity to accumulate earnings tax free. This option starts in 2011.
- ***Source rules for income on guarantees*** – The 2010 Jobs Act clarifies the federal tax treatment of guarantee fees as income sourced to the United States if connected to the United States by a domestic payer or by the conduct of a trade or business in the United States.

***Bill Analysis by Greg Roney, Research Division***

**ASSUMPTIONS AND METHODOLOGY:** The methodology used begins with the Joint Tax Committee estimates of the nationwide federal impact by federal fiscal year (Federal fiscal years run from October through September). Fiscal Research adjusted these numbers back to an approximate calendar year tax impact. The next step was to prorate the national numbers to the state impact using Gross State Product data compared to the nation as a whole.

Even though the major provisions of the 2010 Jobs Act are effective for 2010, the fiscal impact for the incentives that would be taken on 2010 tax returns is allocated to the 2011-2012 fiscal year. North Carolina's current reference to the Internal Revenue Code was updated during the last Session to May 1, 2010. Since the 2010 Jobs Act was not enacted until September, 2010, taxpayers are not entitled to these incentives for North Carolina purposes under current law. The 2011 General Assembly does not convene until after 2010 tax forms are published, therefore 2010 tax forms will reflect current law and require taxpayers to add back 100% of the 2010 Jobs Act incentives taken on the federal return when computing North Carolina taxable income. If the 2011 General Assembly adopts the provisions of the 2010 Jobs Act, it is unlikely that conforming legislation could be enacted in time for the fiscal impact to be realized prior to the end of FY 2010-11. Consequently, the FY 2011-2012 column in the table above shows the fiscal impact resulting from tax incentives that would be taken for the 2010 tax year, and those that would be taken for the 2011 tax year.

**SOURCES OF DATA:** US Joint Committee on Taxation, US Bureau of Economic Analysis, NC Department of Revenue

**TECHNICAL CONSIDERATIONS:** None

